

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:KYT:NAS:TL-N-5267-99
HPLevine, ID# 62-09574

date:

to: Chief, Examination Division, Kentucky-Tennessee District
Attention: Revenue Agent Steve White

from: District Counsel, Kentucky-Tennessee District, Nashville

subject:

Conditions precedent to 3rd party contacts

DISCLOSURE STATEMENT

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ISSUE:

Whether the Internal Revenue Service is required first to attempt to secure information from the taxpayer before a 3rd party contact can be made?

CONCLUSION:

The Internal Revenue Service is not required first to attempt to secure information from the taxpayer before a 3rd party contact can be made.

FACTS AND DISCUSSION:

The taxpayer is under examination for the [REDACTED] taxable period. It submitted additional information to the Appeals Office in its protest. The Appeals Office has released jurisdiction and has requested the Examination Division to consider the new facts submitted by the taxpayer. It is necessary to develop the facts and make 3rd party contacts to do so. Since the issue involves the contemporaneous intent of the taxpayer in the classification of fund transfers as debt or equity, it is necessary to see what representations were made to 3rd parties with whom the taxpayer has had contact. Specifically, this includes the accountants performing the certified audit and the State of Ohio. Although the taxpayer claims the transfers to be equity, the transfers were initially reported as debt to the State of Ohio. The [REDACTED] period was examined by the State of Ohio and the debt classification was not changed. It was only after the Internal Revenue Service identified the issue that the debt was reclassified to equity and the State of Ohio informed of the change. The taxpayer claims that based on an Internal Revenue Service announcement, 3rd party contacts can only be made after the taxpayer has been presented with a chance to produce the information sought by the Internal Revenue Service from the 3rd parties.

The 1998 Restructuring and Reform Act modified I.R.C. § 7602(c) to include three specific requirements: (1) that pre-contact notice of possible 3rd party contacts be provided; (2) that the contacts be recorded in writing; and (3) that the contacts be reported. The taxpayer is to periodically be provided with a list of the contacts. Pre-contact notice of specific contacts is not required. In fact, the Senate Finance Committee initially included pre-contact notice of specific contacts but this proposal was modified by the Conference Committee and was not included in the final legislation.

Consistent with the legislative history, Chief Counsel and the National Resource Center have both concluded that the pre-contact notice provision neither requires pre-contact identification of specific 3rd parties, nor does it give the taxpayer a right to prevent the contacts.

On March 22, 1999, the Internal Revenue Service announced a policy change (IR-1999-28) in order to reduce the need for sending out third-party contact letters to taxpayers. The taxpayer claims that the announcement requires that the Internal Revenue Service first seek the information from the taxpayer before third-party contacts can be made. We disagree.

IR-1999-28 indicates that the change was made to reflect the Internal Revenue Service's long-standing policy of contacting 3rd parties only as a last resort which would mean for the vast majority of field examinations that the 3rd party notice would be sent only if the Internal Revenue Service was unable to collect the needed information from the taxpayer. The objective of the announcement was to prevent 3rd party notification letters where there was no need to contact outside parties, which had the effect of needlessly alarming taxpayers.

IRM 4235 discusses the circumstances surrounding 3rd party contacts. IRM 4235(1) acknowledges that despite the fact that a taxpayer cooperates, 3rd party information may be needed in in-depth examinations. IRM 4235(2) reflects that a third party investigation may be the only method available to arrive at an accurate conclusion. IRM 4235(5) recognizes the importance of 3rd party contacts. The totality of the policy considerations contained in IRM 4235 and IR-1999-28 is merely that unnecessary 3rd party contacts should be avoided, and that the information should first be secured from the taxpayer to the extent possible.

The issue in this case concerns the appropriate classification of amounts as debt or equity involved in transactions between related parties. You intend to make a 3rd party contact with the State of Ohio in order to determine the representations made by the taxpayer concerning their classification of these amounts as debt. We understand that the State of Ohio audited the taxpayer's franchise tax liability for the same period. In a closing conference, we understand that the taxpayer's Tax Director admitted that he purposefully classified these as debt to avoid Ohio franchise tax. While the taxpayer may have some of the information necessary to make this determination, it may not or may not be able or willing to provide all of the information.

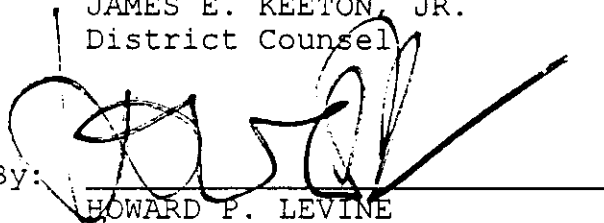
As reflected in the IRM considerations, a 3rd party contact in this instance to determine the representations made to a 3rd party in an attempt to determine the intent of the taxpayer is reasonable under the circumstances. The issue here involves intent, which the courts have found difficult to determine. The Tax Court has acknowledged that this type of information is limited and generally difficult to secure. The Tax Court has refused on occasion to allow privileges to block access to this type of information because of its probative value and since it would be unfair to deny access. See Bernardo v. Commissioner, 104 T.C. 677 (1995). Therefore, while you may want to seek this information from the taxpayer (either before or simultaneously with the 3rd party contact), we see no requirement that you do so in this instance prior to initiating a valid 3rd party contact.

Otherwise, this additional requirement would be tantamount to giving the taxpayer the right to prevent the contacts, which was contemplated neither by the law nor the Internal Revenue Service.

Please contact the undersigned at (615) 250-5072 if you have any questions. Attached is a client survey which we request that you consider completing. The client survey is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you.

JAMES E. KEETON, JR.
District Counsel

By:



HOWARD P. LEVINE
Senior Attorney